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**THE WHITE HOUSE
WASHINGTON**

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CABINET AFFAIRS STAFFING MEMORANDUM

Date: 11/22/85 **Number:** 317028CA **Due By:** _____
Subject: Economic Policy Council Meeting -- November 26, 1985 --
 1:00 P.M. -- Roosevelt Room

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
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Chief of Staff	<input checked="" type="checkbox"/>	<input type="checkbox"/>		<input type="checkbox"/>	<input type="checkbox"/>
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EPA	<input type="checkbox"/>	<input type="checkbox"/>	DPC	<input type="checkbox"/>	<input type="checkbox"/>
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REMARKS:

The Economic Policy Council will meet on Tuesday, November 26, at 1:00 P.M. in the Roosevelt Room.

The agenda and background papers are attached.

RETURN TO:

☒ Alfred H. Kingon
 Cabinet Secretary
 456-2823
 (Ground Floor, West Wing)

☐ Don Clarey
☐ Rick Davis
☐ Ed Stucky

Associate Director

THE WHITE HOUSE

WASHINGTON

November 22, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER

SUBJECT: Agenda and Papers for the November 26 Meeting

The agenda and papers for the November 26 meeting of the Economic Policy Council are attached. The meeting is scheduled for 1:00 in the Roosevelt Room.

The first agenda item will be the Federal Home Loan Bank Board's Section 406 Corporation. The Working Group on Financial Institutions Reform has studied the Section 406 Corporation, identified its benefits and drawbacks, and developed several options for an Administration position on the corporation. A paper prepared by the Working Group is attached.

The second agenda item is Canadian lumber. The U.S. lumber industry argues that Canadian pricing practices cause an oversupply of lumber, leading to difficulties for the U.S. industry. The Council will consider recommendations by the Trade Policy Review Group on objectives the U.S. might seek in negotiations with Canada. A paper outlining the proposed negotiating strategy, describing a U.S. International Trade Commission report on current conditions in the softwood lumber industry, and noting Congressional concerns about this issue is attached.

~~Confidential~~ Attachment

THE WHITE HOUSE
WASHINGTON

ECONOMIC POLICY COUNCIL

November 26, 1985

1:00 p.m.

Roosevelt Room

AGENDA

1. FHLBB's 406 Corporation
2. Canadian Lumber

THE WHITE HOUSE

WASHINGTON

November 22, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: THE WORKING GROUP ON FINANCIAL INSTITUTIONS REFORM
SUBJECT: Federal Asset Disposition Association

Issue: Should the Administration seek to block or restrict the activities of the Federal Home Loan Bank Board's newly formed private corporation, the "Federal Asset Disposition Association?"

The Federal Home Loan Bank Board (FHLBB) recently chartered a private corporation, the Federal Asset Disposition Association (FADA), capitalized by the Federal Savings and Loan Insurance Corporation (FSLIC) to more rapidly and efficiently dispose of assets acquired by FSLIC from failed institutions. FADA creates a dilemma for the Administration. It is a step by the FHLBB to address a concern: FSLIC's declining liquidity and increasing portfolio of bad assets. However, FADA also raises the potential for increased Federal budget and credit obligations.

Background

A substantial portion of the thrift industry has negative net worth, representing a financial threat to the economy and a Federal budgetary threat through the Federally backed FSLIC.

Condition of the Thrift Industry

The traditional structure and purpose of the thrift industry is to borrow short and lend long. This created a "portfolio mismatch" within the industry. As interest rates rose sharply in 1980 and 1981 and thrifts' costs of attracting deposits exceeded returns on assets -- largely fixed rate mortgages, many of which had originated during periods of relatively low interest rates -- the industry experienced substantial and widespread losses.

Loss of earnings and net worth in turn encouraged some thrifts to pursue strategies of rapid growth and higher returns on risky assets which created an industry problem of poor asset quality.

Beginning in 1983, declining interest rates improved earnings and net worth for a segment of the thrift industry. A shake out of nonviable institutions is not complete, however, and the remainder of the industry must still

- 2 -

restructure to recover fully within a deregulated financial environment. Approximately 14.6 percent of the industry (469 of 3,207 institutions) maintains a negative net worth as measured by generally accepted accounting principles. Moreover, 263 thrifts (representing \$91 billion in assets), or 8.2 percent of the industry have been identified by FSLIC as likely failures. Many, perhaps most, of these 263 will require assistance from the FSLIC,

Potential FSLIC exposure

FSLIC obtains its resources through premiums collected from insured institutions and interest on its portfolio. These add about \$2.0 billion a year to the FSLIC fund. The FSLIC currently has \$6 billion in equity, one third (\$2 billion) of which represents unobligated funds available now for use in acquiring the liabilities of failed institutions. Total FSLIC exposure is highly uncertain and could range as high as \$30 billion based upon anticipated additional failures within the industry.

Creation of FADA

On November 5 the FHLBB announced creation of a corporation, the Federal Asset Disposition Association (FADA), under the authority of Section 406 of the National Housing Act of 1934, to help the FSLIC profitably dispose of assets assumed from failed thrifts.

FADA has been chartered by the FHLBB as a private savings and loan institution which would purchase assets from the FSLIC and dispose of them by hiring specialists to sell them on an incentive compensation basis or through contracted services. The current charter prohibits FADA from accepting deposits. The FSLIC will provide the initial capital to the corporation. FADA would derive much or all of its start-up equity from the FSLIC and could leverage that base through borrowings, most likely from Federal Home Loan Banks. However, there is nothing in its charter to prevent FADA from seeking other investors or borrowing directly from the public.

The FHLBB has appointed a board of eleven directors to serve on the FADA board and a search has begun for a chief executive officer.

FADA and the FCSCC

FADA would differ in important ways from the Farm Credit System Capital Corporation (FCSCC) established earlier this year by the Farm Credit System (FCS) and viewed by the Economic Policy Council as integral to the proposed solution to the FCS's liquidity problems.

- o The purposes of the two entities differ. The FCSCC was intended to redistribute capital within the FCS by

- 3 -

purchasing poor quality assets and forcing segments of the System to bear any market losses from liquidating the assets. FADA, on the other hand, is intended to provide liquidity to the FSLIC by disposing of assets assumed by the FSLIC from failed institutions.

- o The FCSCC was capitalized solely by privately owned funds, while FADA would be capitalized by FSLIC-owned funds. FSLIC equity in FADA could be viewed as explicit Federal support for the activities of the entity -- an avenue rejected for the FCSCC.
- o Stockholders of the FCS are jointly and severally liable debt offerings of the FCS and the FCSCC. FSLIC, on the other hand, would implicitly, or directly, guarantee FADA debt.
- o The FCSCC purchases the bad assets of FCS institutions, while FADA, intended to liquidate the assets of failed institutions acquired by the FSLIC, could be pressured to assume bad assets of solvent thrifts.
- o The FCSCC's pooling operations will be used in conjunction with a tough regulatory scheme including generally accepted accounting principles to define net worth. FADA is not part of a change in the regulatory approach to thrifts.

Advantages and Disadvantages of FADA

The Working Group has identified the following advantages and disadvantages of FADA:

Advantages

- o FADA could bring more expertise and efficiencies to the operation of liquidating FSLIC-held assets from failed thrifts. The FSLIC has been unable thus far to dispose of the assets from failed thrifts as rapidly as it takes them in (the FSLIC portfolio of such assets is \$2.2 billion).
- o FADA, unlike the FSLIC, may not be hampered by Federal personnel restrictions and could flexibly hire specialists under incentive compensation arrangements to profitably manage liquidation.
- o FADA purchases from the FSLIC would improve the FSLIC's unobligated balance, potentially permitting the FSLIC to liquidate insolvent thrifts more rapidly.

Disadvantages

- o FADA could increase Federal budget exposure and exacerbate the thrift industry's financial problems. Should FADA buy bad assets from solvent institutions, Federal obligations

would be implicitly extended from protecting insured deposits to include uninsured depositors and debt holders.

- o In the extreme, FADA and the FSLIC might be able to direct at what rate to infuse capital into the thrift system without consulting with the Executive or Legislative branches. FSLIC already can borrow substantial sums directly from the Federal Home Loan Bank System, but its use of those funds is subject, unlike FADA, to OMB apportionment.
- o FADA creates conflict of interest problems. As a Federally owned, privately operated entity, FADA may face difficult conflict of interest problems involving the interests of management and those of the FSLIC. Conflict of interest problems would also arise should shareholders other than FSLIC hold an interest in FADA.
- o Although FADA's charter is sunset at 10 years, FADA could become permanent or set a precedent in the interim for similar requests for assistance in disposing of bad farm credit or international debt.

Possible Alternatives

There are several possible alternatives to the FADA proposal:

- o Auction: The Working Group has suggested to the FHLBB undertaking a pilot project to test the feasibility of a direct auction of FSLIC assets. FSLIC could contract with private sector real estate and financial experts to assist FSLIC in taking inventory, valuing its assets, and structuring an auction process. This approach is preferred by the Working Group because it would directly utilize market incentives and competition.
- o Contracting out: Despite the FHLBB's dissatisfaction with the results of its contracting out efforts to date, contracting out might accomplish many of the goals of the new corporation while avoiding the need to establish a quasi-governmental entity. In addition to contracting with private companies, FSLIC could contract with the Home Loan Banks or the FDIC, if appropriate expertise were available at these organizations.
- o Handle the problem in-house: FSLIC staff could be expanded to handle the liquidation problem. Management and personnel problems could be alleviated through administrative or legislative relief from Civil Service laws.

Options

Since the announcement regarding the chartering of FADA, the Working Group has been discussing with the FHLBB: (1) imposing

- 5 -

various restrictions on the purpose and activities of FADA and
(2) creating a pilot program to auction bad assets held by FSLIC.

It also should be noted that one of the three positions on the Federal Home Loan Bank Board is open now and another will open in June 1986.

The Administration faces four options:

Option 1: Continue jawboning the FHLBB to restrict the purpose and activities of FADA and to create a pilot program for auctioning bad assets held by FSLIC.

The FHLBB has already chartered FADA and, absent some restrictive action, the FHLBB will be able to fund FADA and guarantee its debt without consulting with the Executive and Legislative branches. A list of restrictions that should be placed on FADA is contained in an appendix.

Advantage

- o Avoids a public confrontation between the Executive Branch and an independent regulatory agency.

Disadvantage

- o Concedes the chartering of a new quasi-governmental entity that could obtain most of its funds using FSLIC-guaranteed debt and, if not properly constrained, could purchase assets from solvent thrifts, increasing potential Federal outlays.

Option 2: Use OMB's apportionment process to a) block or b) restrict FADA.

Under this approach, OMB would apportion funds in a fashion that would preclude their use for FADA purposes. Failure to adhere to OMB apportionment would be in violation of the Antideficiency Act, and subject to legal penalties.

Advantage

- o If successful, would prevent the start up of a quasi-governmental entity and might improve the Administration's ability to advance other alternatives and/or might force the FSLIC to make greater use of alternative approaches to asset disposal.

Disadvantages

- o Could be ignored by the FHLBB, requiring enforcement through legal actions against officials of the FHLBB by the Justice Department.

- 6 -

- o Could lead to congressional action to curb OMB apportionment authority over the FHLBB and other independent agencies.

Option 3: Continue jawboning the FHLBB to restrict the purpose and activities of FADA and to create a pilot program for auctioning bad assets held by FLIC. Convey to the FHLBB that OMB will initiate apportionment proceedings unless the FHLBB specifies that:

- FADA will not accept deposits or directly issues debt.
- FADA will not purchase assets directly from thrifts.
- Profit interests in FADA stock will be held only by the FSLIC.
- FADA will not provide a significant amount of seller financing.

Advantages

- o Avoids a public confrontation between the Executive branch and an independent regulatory agency.
- o Sends a strong, and timely, signal to the FHLBB of our Administration preferences.

Disadvantages

- o Concedes the chartering of a new quasi-governmental entity.
- o Apportionment is a blunt tool. Under this option we would commit ourselves to its use, without knowing the circumstances under which apportionment would have to be used.

NOTE: Neither FADA nor any of the alternatives address the most fundamental issue: the very low net worth of many thrift institutions. The Working Group will focus its efforts on that issue in the coming months.

ADDENDUM

The Working Group suggests that the following restraints be included in the FADA charter and by-laws:

- o FADA should not be permitted to raise money in the financial markets nor to accept private deposits.
- o Any assets transferred from FSLIC to FADA should be at fair market value.
- o FADA should perform no activities other than the workout of problem FSLIC assets. FADA should not be allowed to purchase assets from any entity other than FSLIC.
- o FADA should disclose after the final sale of the asset its purchase price from FSLIC and, its final sales price.
- o No outside profits interest in FADA should be permitted.
- o FADA should not be FSLIC's exclusive disposal agent and other alternatives should be vigorously pursued.
- o FADA should neither be permitted to provide any significant amount of seller financing nor to hold any such loans for more than 2 years.
- o Stringent prohibitions against self-dealing should be developed and adopted.

We might also want to consider whether exclusive disposal agent and other alternatives should be vigorously pursued.

CONFIDENTIALCanadian LumberIssue

U.S. lumber mills are under economic stress, particularly along the Canadian border and throughout much of the South. In spite of the fact that U.S. production has increased 30 percent in terms of quantity and 47 percent in terms of value between 1982 and 1984, profit margins have not increased. The industry is blaming Canada for its ills, arguing that lower Canadian prices -- caused by an oversupply situation as a result of non-market oriented stumpage pricing -- have depressed the market overall. The industry is pressing strongly for either legislative or administrative action against the Canadians.

Congressional pressure is coming from two directions: (1) the Gibbons' natural resource subsidy bill and (2) threats to hold up Administration efforts to enter into "free trade" negotiations with Canada. The EPC has indicated its preference for a negotiated solution rather than a confrontational approach in order to minimize damage to the overall relationship with Canada and the prospects for a "free trade" agreement. The EPC needs to decide on an appropriate negotiating strategy to pursue with the Canadians.

Recommendation

1. In order to assist the U.S. industry and to forestall Congressional action on lumber, the EPC should adopt a strategy which combines bilateral negotiations with Canada and aggressive efforts to open offshore markets.
2. The Administration should work closely with the U.S. industry and its Congressional supporters in preparing for these negotiations and throughout the process.
3. High-level bilateral negotiations should commence immediately and should have the following objectives:
 - o address the questionable elements in Canada's stumpage systems, e.g., profit and risk components and under-valuation of the by-product wood chips;
 - o elimination of Canadian log export restrictions;
 - o reduction of Canadian tariffs on imports of U.S. finished wood products; and
 - o adoption by Canada of satisfactory plywood performance/prescriptive standards.

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- 2 -

4. The Administration should also intensify efforts, working jointly with the Canadian Government, to reduce other nations' wood products tariff and nontariff barriers.
5. The U.S. and Canadian Governments should coordinate their official export promotion activities for the wood products industry. The U.S. and Canadian industries should also be encouraged to continue their joint export promotion efforts.

Background

A. The USITC Report

On March 6, the Office of the U.S. Trade Representative asked the U.S. International Trade Commission to examine the current conditions in the softwood lumber industry. The report is factual and does not offer recommendations for action.

In general, the report did little to bolster U.S. industry's overall case against Canadian softwood lumber imports, although there are some findings favorable to U.S. industry which could provide bargaining points. The findings confirmed the fact that Canadian stumpage prices are much lower than U.S. stumpage prices. Between 1977-84, average U.S. stumpage prices were approximately seven times higher than Canadian prices. Further, British Columbia undervalues wood chip prices in their appraisal system, and the report states that Canadian producers in interior British Columbia enjoy a much higher profit and risk factor in their stumpage valuation than U.S. producers. In addition, the USITC found that aggregate delivered log costs to the mill were also higher in the United States -- contrary to Canadian claims -- by about US\$47 per thousand board feet between 1977-84.

There is little economic reason that the U.S. forest product industry in general and lumber in specific should not be highly competitive at home and abroad. Current problems may be closely related to domestic policy. The high value of the dollar has not helped exports and may have benefitted Canadian imports. In this respect lumber only shares a problem felt by the whole U.S. traded goods sector. The problem in providing relief to any one industry from trade pressures created by the dollar is that the trade balances of other industries are likely to be further weakened once all the economic adjustments are made (dollar exchange rate) to the impact of reduced imports in the protected sector. The answer on the dollar for lumber and all other traded goods industry is the same: reduced Federal spending and deficits, and stronger growth abroad. A more detailed economic background can be found in Appendix A.

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- 3 -

B. Congressional Concern

U.S. lumber mills brought a subsidy case against the Canadians a couple of years ago, but the Commerce Department held that Canadian stumpage practices are not a subsidy under U.S. law. A summary of Commerce's Canadian lumber decision is included at Appendix B. Since then many Members of Congress have been pressing for legislation that would change the subsidy definition to encompass the Canadian practices. This has become a major political issue with at least 50 Members with substantial timber interests in their states, including Senators Packwood, Symms, McClure and Baucus, Congressman Craig and others. There are 12 Republican Senators up for reelection in 1986 who are interested in the lumber issue. Also attached is a letter from 38 Members urging action on lumber (Appendix C).

In addition, many of these same Members are threatening to hold up any Administration request to enter into "free trade" discussions with Canada unless action is taken on lumber. A letter from half of the Senate Finance Committee to this effect is attached (Appendix D).

C. Domestic Policy

The competitiveness of the U.S. softwood lumber industry is affected by domestic measures as well as imports. Highlighting this fact to the U.S. Congress could help relieve some of the pressure on trade policy to cure all the ills of the domestic industry. Appendix E contains a discussion of these domestic measures.

D. Negotiating Strategy

The first step toward achieving a negotiated settlement would be to inform U.S. industry and key Members of Congress that the Administration is prepared to reopen bilateral negotiations on softwood lumber. We would work with industry to refine our negotiating package. A more aggressive Administration posture on the issue will be helpful in easing the current protectionist atmosphere on the Hill.

We must also move swiftly on lumber to gain credibility in Congress for opening the broad free trade negotiations with Canada. A firm resolve to deal with a complex and widely-perceived unfair trade situation will provide a better climate for seeking Congressional acquiescence to initiating formal negotiations.

The negotiations themselves would take a package approach which would address softwood lumber pricing, attempt to resolve some tariff and plywood standards issues, eliminate

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- 4 -

log export restrictions in Canada and joint market opening activities to help alleviate oversupply problems.

We should also let the Canadians know that we consider their willingness to work with us on resolving the lumber issue is necessary for gaining Congressional support for the "free trade" negotiations.

The objectives of the negotiations with Canada would be:

1. Address Questionable Elements of Canadian Stumpage Systems

The domestic industry has emphasized the "unfairness" of the Canadian stumpage system. In particular, they questioned the higher amount allocated for profit and risk under the Canadian system, no provision in the Canadian scheme for reforestation costs (not addressed to any extent by the USITC), and a lower starting point under the Canadian appraisal system (substantiated somewhat in USITC report).

2. Reduction of Canadian Tariffs on Finished Wood Products

Canadian tariffs on finished wood products are generally higher than those on equivalent products in the United States. U.S. interests seek the equalization of U.S. and Canadian tariffs on moulding and millwork, hardboard, and particleboard. This could be accomplished as a two-step process, with immediate reductions to U.S. levels followed by further cuts to zero as part of an FTA.

3. Harmonization of U.S. and Canadian Standards on Plywood

Canadian standards on softwood plywood effectively preclude 65 percent of U.S. plywood from the Canadian markets. Efforts after the Tokyo Round at industry-to-industry talks on harmonization of U.S. and Canadian standards failed.

4. Elimination of Canadian Log Export Restrictions

The Northwest Independent Forest Manufacturers, an association of small, independent mills in the Northwest, has been seeking access to cheaper Canadian timber for some time. A bilateral, preferential agreement providing access to unprocessed logs would be of significant benefit to mills along the border. Such an agreement should be

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- 5 -

consistent with our GATT obligations. Other regions of the U.S., however, would not benefit due to high transportation costs.

5. Joint Efforts by Canada and the U.S. to Open Third Country Markets

The Administration should also intensify its efforts to open offshore markets for lumber and wood products. U.S. exports of lumber only account for 6 percent of U.S. production. Principal markets, aside from Canada, include Japan, Australia, Italy and Mexico. Given that overproduction in North America is a principal cause of the U.S. industry's woes, aggressive Administration efforts to improve U.S. access to these markets could alleviate some of the downward pressure on prices. As any successful U.S. efforts to open offshore markets will also help the Canadian industry, this could be something the Canadian Government could point to as part of an overall solution which benefits them. The Administration should coordinate its efforts with the Canadian Government to maximize the effort.

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CONFIDENTIALAppendix AECONOMIC BACKGROUNDCANADIAN LUMBER ISSUEDo Stumpage Price Differentials Mean Canada is Subsidizing the Log Input into Lumber?

Market conditions for lumber resemble those for many natural resource industries. The price received by producers is determined in distant markets where the product is used (especially Sunbelt home construction for Pacific Northwest lumber industry). Transportation costs being high, producer costs are strongly influenced by the distance of both the tree to the lumber mill and the lumber mill to the point of final use. (Lumber milling operations are thought to be economically rational only within 200 miles of stumpage.) The closer the timber source and producer are to the user, the lower are transportation cost and the greater the potential profit (or economic rent). Conversely, the farther the stumpage and lumber mill from final user, the lower a free-market price should be for both logs and board foot of lumber. (Price disparities for lumber, however, will be much smaller than for logs or stumpage because of lower transportation costs for lumber.) Such price disparities exist within the United States as well as between U.S. and Canadian producers. Lower Canadian stumpage prices and lower board foot prices from the mill, therefore, do not a priori demonstrate the existence of a subsidy.

The U.S. industry asserts that such a subsidy element exists in Canadian provincial stumpage pricing practices, particularly in British Columbia, and that the U.S. industry, particularly in the Pacific Northwest, is injured as a result of the subsidy. The current evidence is, however, inconclusive as to the extent to which these practices confer an economic advantage to Canadian lumber producers.

The ITC reported in its investigation last month that between 1977 and 1984 Canadian stumpage prices (as measured in dollars per thousand board feet) varied between 11 percent and 23 percent of U.S. stumpage prices. However, the ITC noted that, "owing to the differences in the measurement systems and the types of timber harvested in the United States and Canada, direct comparisons between the prices paid for stumpage (stumpage and timber dues in Canada) and delivered costs of logs are difficult to

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make. Of particular concern are the differences resulting because of the various species, quality, and grade of timber marketed."

Data on differences in stumpage fees within the United States at least as large as those between the United States and British Columbia show that such conditions can exist even where no subsidy element is present. As the table below shows, stumpage prices in region 2 of the United States (Colorado and surrounding states) are like British Columbia's stumpage prices, below U.S. average prices by a factor greater than ten at times:

Year:	Region 2 (Colorado and surrounding States) (U.S.\$/thousand board feet)			British Columbia
	United States		Canada	
1977	96.41	14.4	10.16	9.9
1978	118.76	24.7	21.59	22.7
1979	134.37	8.1	30.96	38.8
1980	122.16	96.1	27.48	36.3
1981	140.98	9.1	12.09	11.8
1982	93.57	5.5	10.57	9.7
1983	105.99	12.9	11.63	11.0
1984	104.16	12.8	11.84	10.3

This comparison is intended only to show that there are major differences in stumpage prices in the United States and is not meant to imply that the Colorado stumpage is comparable to the British Columbian stumpage.

The October 1985 ITC investigation pointed out that valuation of lumber in interior British Columbia contains a profit and risk factor totaling some 30 percent of appraised stumpage value. In the United States this factor is between 9 and 18 percent. Moreover, whereas in the United States the profit and risk factor figures only in the calculation of the minimum stumpage fee (the actual fee being normally set by auction), in Canada this factor is a key determinant of actual stumpage fees. Although a higher risk premium might be justified for interior stumpage in British Columbia on the grounds of its residual supplier status, this differential may provide higher returns to Canadian producers than would a more market-based system and encourage higher levels of Canadian production.

Similarly, it has been asserted that price difference between legislated value for wood chips in British Columbia and current chip market prices contains a subsidy element. The ITC did find that the valuation of wood chips in interior British Columbia was below prevailing market prices and that the difference translated to about \$20.00 per thousand board feet when the appraisal price

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3

was based on wood chip prices. However, the ITC also found that this difference was nullified when minimum stumpage prices were used instead of appraised prices. Minimum prices are used when the appraisal system results in negative or very low price and these minimum prices have been common since 1981.

The existence of economic rents suggests the existence of imperfections inherent in the market for timber from publically owned lands. The Canadian system, as represented by the practice in British Columbia, is designed to deal specifically with this market imperfection. Stumpage prices are determined by Canadian authorities as a residual price after lumber milling, transportation, profit and risk premiums are subtracted from the current market price for lumber. The provincial authority, in theory, attempts to capture all the economic rent. The Canadian lumber manufacturer receives indexation of the stumpage price he must pay thus being protected against both loss in periods of declining lumber prices (when stumpage prices are adjusted downward) and extra large profits in periods of rapidly rising lumber prices (when stumpage prices are adjusted upward).

The problem of subsidy or economic distortion could arise in two ways:

1. Rather than eliminating all rents as the theory suggests, does this system actually tend to operate in such a way as to maintain Canadian production at artificially high levels? The large allowances for profit and risk suggest that this could be the case.

2. Is the practical application of the system such as to confer an advantage on Canadian producers? The fact that all stumpage fee transactions in British Columbia are carried out at an administratively determined price raises questions as to whether the mechanism for determining this price confers some economic advantage to firms in that province.

British Columbia officials calculate stumpage fees on a residual basis -- taking the market price for lumber in a given U.S. port and then deducting transportation costs, milling costs and an allowance for profit, with the residual in principal equal to the stumpage fee. At any point in the sequence of monthly calculations, underestimating lumber prices or overestimating production costs or risk premiums could lead to profitability for Canadian firms in excess of what is set by the provincial authorities. Were this the case, it would not be difficult to argue the potential for negative trade repercussions in U.S. lumber markets. Such a factual determination on Canadian practice, however, has not been made, and would be apparently be difficult without some cooperation from Canadian provincial authorities. Consultations with Canadian authorities could help clarify some disturbing aspects of Canadian stumpage pricing practices.

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Differences in the U.S. and Canadian Stumpage Pricing Systems:
Recent Move of U.S. Forest Service Toward Canada-like Indexation

British Columbia and the United States have until recently had systems for pricing stumpage on Federal/provincial lands fundamentally different in some respects. The system in British Columbia tends to lock lumber producers into longterm supply contracts, but price is adjusted monthly to reflect market conditions. In the United States, until recently, Federal auction procedures locked many lumber producers for a number of years into a stumpage price reflecting market conditions at the time of auction (the so-called flat price system). This was particularly true in the Pacific Northwest where before 1982, 75 percent to 80 percent of stumpage contracts with the Forest Service were flat priced. The Forest Service had greater security concerning the projection of its revenues from stumpage sales. However, the system created substantial risk for U.S. lumber producers. Boom and bust cycles in construction accentuate market price fluctuations for lumber. In fact, U.S. lumber producers currently face problems with contracts signed in the late 1970s and early 1980s at prices which subsequent market conditions rendered excessive. While U.S. producers entered these contracts freely, it also appears that Forest Service auction procedures for his input (logs) increased risk for the private producer in a market characterized with wide price fluctuations for his output (lumber). By frequent price adjustment, the system in British Columbia, subsidy question aside, apparently does more to stabilize the market.

The Administration has responded to the difficulties created for Pacific Northwest lumber producers by the high prices contained in the contracts in the late 1970s early 1980s. We supported the Timber Relief Modification Act, which allows companies to escape their contractual obligations if the market downturn subsequent to their bid rendered the contract uneconomic. The length of time before penalties are imposed for delaying actual cutting was extended by five years in 1983. To date about 9.7 billion board feet have been returned to the Government. The problem for the lumber producers, however, will only be resolved to the extent that lumber prices rise sufficiently in the five year time frame to justify the high stumpage prices in the original contracts. Pressures continue to increase for further Federal action to relieve the domestic producers in the Pacific Northwest.

Since 1982, the Forest Service has adopted in Western Washington and Oregon a stumpage pricing system that contains an escalator clause that parallels existing stumpage pricing policies on most national forests in the rest of the country. Lumber companies continue to bid at auction for stumpage with the contract price reached independently of the Forest Services appraised value of the stumpage. (The Forest Service uses a residual appraisal system similar to that of British Columbia.) Once the price is set by

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5

auction, however, it is indexed by the Forest Service to an index of lumber prices (the so-called escalator clause). Indexation protects lumber producers against unexpected reductions in lumber prices and the Government against unexpected increases in lumber prices. Indexation, however, is incomplete and the Forest Service stumpage price system continues to differ from the system in British Columbia in two important ways. First, lumber companies in British Columbia accept the residual appraisal price made by Provincial authorities as their initial contract price, while for U.S. lumber companies the initial price is set by auction and usually differs (exceeds) the Forest Services appraisal price for stumpage. Second, while the stumpage price is fully indexed in British Columbia, there is a cap to indexation in the United States. A formula is used to estimate a maximum extent for both upward and downward stumpage price adjustment. The Forest Service reports that while the caps determine a wide enough band so that they are usually not reached by price adjustment, there have been cases where the Forest Service was prevented from lowering stumpage prices to the full extent implied by falling lumber prices because of the existence of the lower cap. U.S. lumber producers in the Pacific Northwest reportedly opposed such indexation for years, but found the system more attractive after their problems with falling lumber prices in the early 1980s.

U.S. industry asserts that Canadian companies do not have to meet the same reforestation obligations as imposed in the U.S. and that this confers a competitive advantage to Canadian producers. This point is not adequately addressed in the ITC report and it needs to be explored fully with Canadian officials. Reforestation requirements are handled differently in the U.S. Pacific Northwest and in British Columbia. The U.S. Forest Service undertakes reforestation directly in lands it administers. The Forest Services assures that its reforestation costs are included in its assessment of minimum stumpage fees. In contrast, British Columbia carries out reforestation by imposing administrative requirements on loggers. Canadian officials assert that under Provincial law logging companies would be ruled ineligible for future bidding if they have not fulfilled their reforestation obligations. The actual operation of the system and its economic impact are subject to question.

How the U.S. Industry Got into Its Present Difficulty: A Hypothesis

About one-third of U.S. domestic production of softwood lumber comes from Federal lands. Federal pricing policies influence the whole domestic market. The pricing system used by the Forest Service, when it contained the flat price clause described in the previous section, may have acted during the period of high inflation to destabilize the U.S. market. Lumber companies were forced then to speculate on future lumber prices when they bid on longterm stumpage contracts. In the inflationary 1970s stumpage

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prices spiraled up, reflecting like other commodity prices the expectation of continuous and strongly rising domestic prices. Between 1977 and 1981 U.S. stumpage prices rose 46 percent. Between 1981 and 1982, stumpage prices declined by a third as inflation cooled and the economy went into recession. Between 1982 and 1983, however, stumpage prices rose 13 percent and softwood lumber prices at wholesale rose 20 percent. Price increases seem to have been brought to a halt in 1984 as the economy slowed and, perhaps, as the realization grew that, in contrast to past experience, U.S. economic expansion did not necessarily signal rising inflation and exploding commodity prices.

The industry itself has made much of point that U.S. lumber prices usually rise sharply along with U.S. lumber consumption in periods of strong growth. This has not been the experience in the recent recovery as prices of lumber have apparently grown less strongly in this recovery. The industry has attributed this development to unfair Canadian competition forcing them to cut into prices and profits to maintain market share. As noted above, the role of Canadian pricing practices in the smaller than expected (by the U.S. industry) U.S. lumber price increases has yet to be determined factually. An alternative explanation to the problems of the U.S. industry is one of difficult adjustment to domestic disinflation. Stumpage contracts without indexation proved extremely costly to lumber firms when lumber prices receded with inflation. With disinflation the price increases for lumber have not appeared which would have salvaged past contracts signed at too high a price for stumpage. Some in the industry have serious problems -- problems which higher prices would greatly alleviate. Whether or not Canadian stumpage pricing practices are responsible for keeping current prices low, restrictions against Canadian imports potentially would raise the lumber prices received by Northwest producers.

How Serious are the Problems of the U.S. Producers?

Another question is how serious the economic difficulties of Pacific Northwest producers actually are. They argue that imports have kept prices abnormally low. However, data do not clearly support this assertion.

Imports have grown substantially in the last two years, but not out of line with the growth of domestic demand. Imports as a share of consumption increased slightly from 28 percent in 1982 to 29 percent in 1984. Imports as a share of consumption averaged 27 percent during the period from 1977 to 1984.

Commodity prices, including those for lumber, are characteristically volatile. Price moves over relatively short periods are not necessarily characteristic of longer-term price trends in commodity prices. Producer prices for softwood lumber are not unusually

low when measured against long-term price trends for other producer prices in the economy. U.S. producer prices have risen by 210 percent since 1967 (210 percent for crude materials and 220 percent for intermediate products). In mid-1985 lumber prices stood 259 percent above their 1967 level for douglas fir, 226 percent for southern soft pine and 277 percent for other softwoods. More recently, the average price per board foot of lumber rose by 14 percent from 1982 (20.3 cents) to 1984 (23.1 cents). While U.S. producers would benefit from higher prices, the case for softwood lumber prices being abnormally low is not clear, particularly in light of the price moderation throughout the commodities area.

The profits of paper and forest product firms have fallen by 22 percent in the first nine months of 1985 as compared to the same period of 1984. (All U.S. industry profits dropped 10 percent.) But, the paper and forest products firms remain profitable. The average profit margin was 5.3 percent in the third quarter of 1985 (compared to a 7.2 margin in 1984's third quarter). Return on common equity was 7.2 percent for the year ending September 30, 1985. (Note should be taken that profits in non-soft wood lumber activities may be masking poorer profit performance for lumber operations in these large, diversified forest product firms; recent profit data on softwood lumber operations alone is extremely difficult to locate)

Smaller, independent lumber firms have reportedly been more hurt by past stumpage contracts at high prices. One industry representative has cited a figure of 250 for the number of mills which have recently gone out of business. Commerce Department data show that the number of U.S. establishments fell from 7,544 in 1977 to 6,316 in 1982 (under the impact of improved technology and resulting stiff competition and concentration in the view of ITC). From 1982 to 1984 the number of establishments rose from 6,316 to 6,560 as the U.S. construction industry moved into high gear.

Summary of Commerce's 1983 Countervailing Duty Investigations

In 1982 the International Trade Commission (ITC) issued a factual study of conditions in the U.S. softwood lumber industry at the Senate Finance Committee's request. A coalition of lumber producers then filed a countervailing duty petition covering lumber, shakes and shingles, and fence from Canada.

In a controversial decision in 1983, Commerce found no countervailable subsidies as a result of provincial stumpage practices. First, Commerce found that Canadian stumpage practices did not benefit only an industry or group of industries (and thus did not satisfy the "specificity test"). They determined that the availability of stumpage on equal terms without governmental restriction, coupled with sufficiently widespread harvesting by various industries, precluded an affirmative determination.

Second, Commerce found that even if the stumpage practices had benefitted a specific group of industries, they were not a subsidy as defined in the U.S. countervailing duty law. The provinces did not offer stumpage on preferential terms, and therefore did not trigger the subsection covering preferential provision of goods and services. Commerce ruled that the clear applicability of that subsection precluded application of any other subsection.

Commerce then ruled that even if more than one subsection of the countervailing duty law did apply, stumpage practices were not a subsidy under the other possibly relevant subsection covering the assumption of manufacturing costs. The provinces did not assume costs, they imposed them. Nor did they relieve the harvesters of any pre-existing legal liabilities. Commerce then noted that the residual valuation system used by both British Columbia (which accounts for the vast majority of Canadian stumpage harvested) and the U.S. Forest Service was reasonable. Finally, it noted that information in the record of the investigation supported the view that the Canadian stumpage prices would actually equal or possibly exceed U.S. stumpage prices if adjusted for differences in climate, terrain, species, and accessibility.

Commerce found only de minimis subsidies in its investigations, and consequently made negative determinations.

Congress of the United States

House of Representatives

Washington, D.C. 20515

October 29, 1985

**The President
The White House
Washington, D.C. 20500**

Dear Mr. President:

Thanks to the economic recovery you have engineered, demand for lumber, driven by the extraordinary growth in housing starts, is the highest in history. Despite this, lumber prices, which normally follow housing demand very closely, remain at an all-time low, and the industry is suffering severely. It has written off half a billion dollars in assets last year alone, hundreds of mills have closed, thousands of workers are unemployed, and money is not available to manage forest lands adequately.

The cause of this distress is massive lumber over-production in Canada that is sold at distress prices here. Canadian timber is owned by the Provinces which, in a deliberate effort to maintain employment, make it available to lumber producers for one-tenth of the cost of timber in the United States. The U.S. International Trade Commission has just released a study documenting the Canadian practices. The ITC found that even though Canadian logging costs are much higher than ours, Canadian mills can buy timber much more cheaply than our mills, and that this cost advantage is passed through to the final product. Because Canadian producers have access to virtually free raw materials, the market imposes no discipline on them, and they overproduce.

If the Canadians did not supply timber at concessionary prices, but rather put it out for competitive bidding as is done in the U.S., the price would be bid up to market rates, and supply and demand would come into balance. By giving their timber away, they are subsidizing their lumber industry, and exporting their unemployment to the United States.

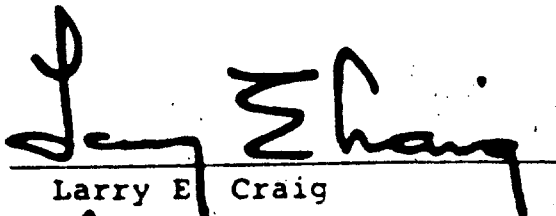
On October 2, 1985, you announced the creation of an administration "Trade Strike Force" designed to uncover unfair trading practices used against the United States. In light of the unfair Canadian practices we just described, and that the ITC report documents, the evidence is clear: the United States domestic timber industry is being devastated.

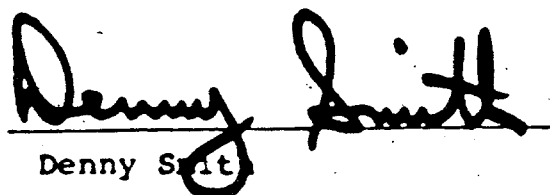
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We, who are impacted by unfair Canadian trading practices, are no less committed in resolving this trade imbalance than what was evidenced in June of this year. When the call went out for a "Timber Summit" with Malcom Baldrige, Max Freiderdorf, and Michael Smith, sixty Members of Congress attended to urge immediate action be taken. We who support you and have to run for election next year urge you in the strongest terms to act quickly and decisively to restore fairness to our lumber market. Also, Ambassadors Yeutter promised us he would act promptly after the ITC issued its report. Your pledge to insure fair trade will ring hollow indeed if you do not act now that the ITC has spoken.

We request a meeting with you at your earliest convenience to plan the Administration's response to this serious problem.

Sincerely,

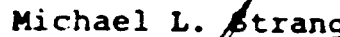

Larry E. Craig

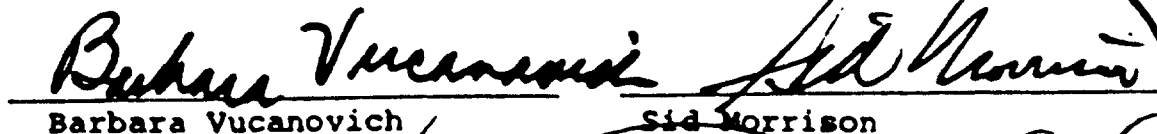

Denny Smith


Trent Lott

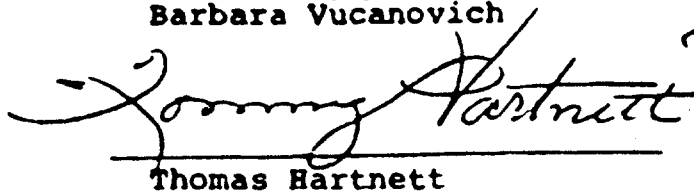

Howard Nielson

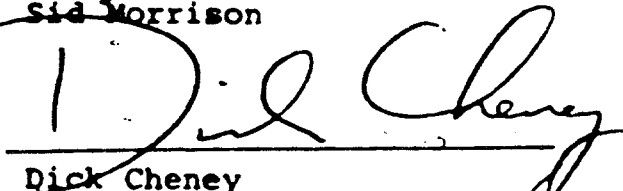

David O'B. Martin

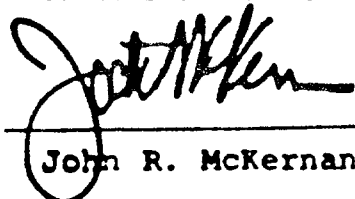

Michael L. Strang

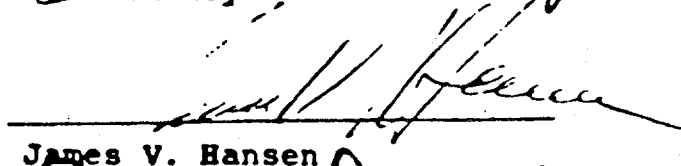

Barbara Vucanovich

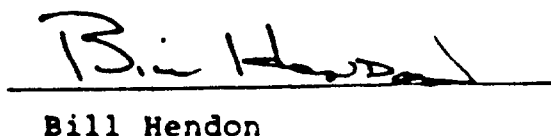

Sid Morrison

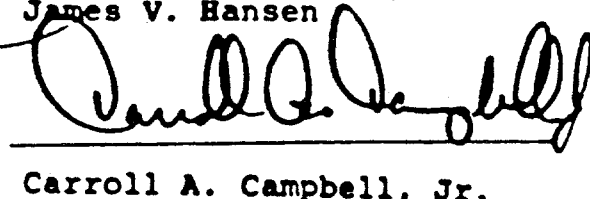

Thomas Hartnett

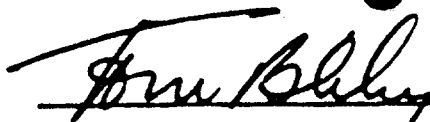

Dick Cheney


John R. McKernan


James V. Hansen



Bill Hendon

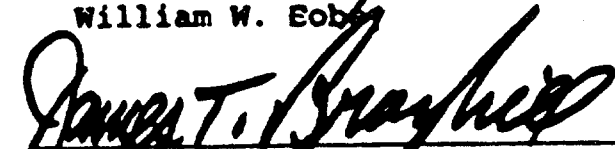

Carroll A. Campbell, Jr.


Thomas J. Bliley



David S. Monson

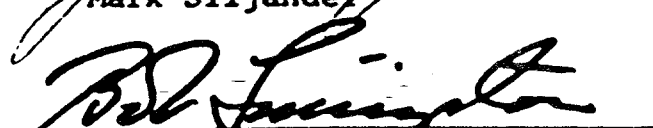

William W. Eoby

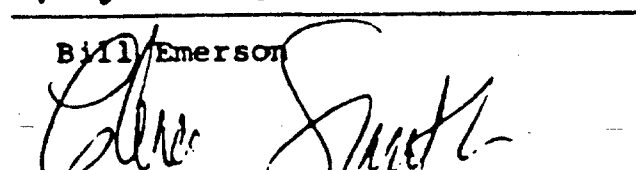

Bob Stump



James T. Broyhill

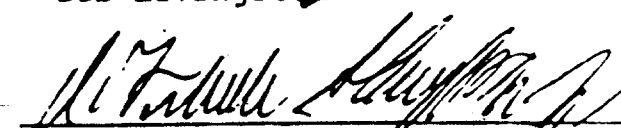

Dan Schaefer

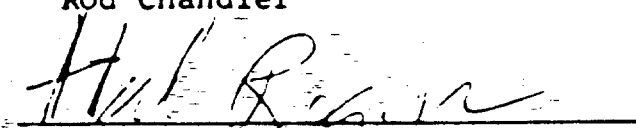

Bill Emerson

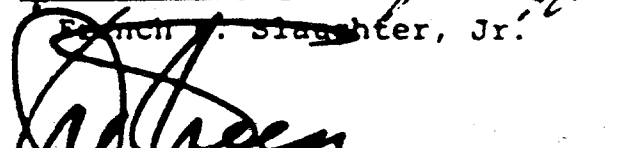

Mark Siljander



Christopher H. Smith



Rod Chandler

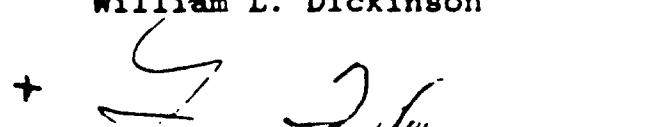

Francis J. Slaughter, Jr.

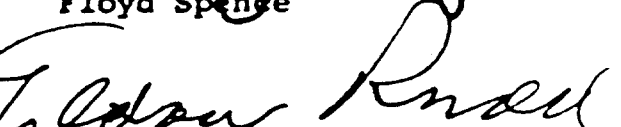

Harold Rogers

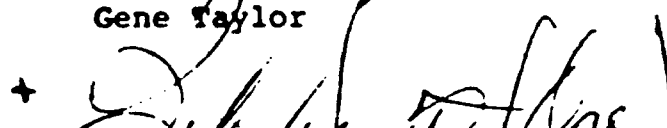

Jack Skeen



William L. Dickinson


Floyd Spence

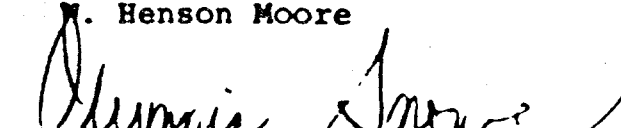
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Gene Taylor

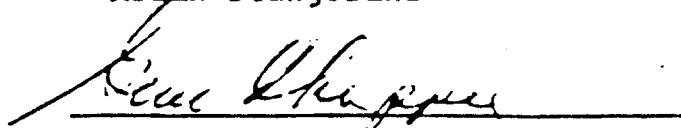

Eldon Rudd

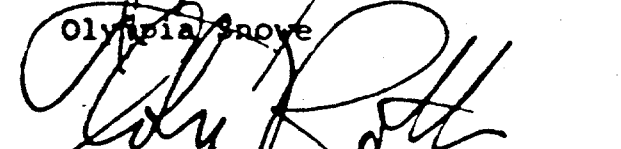
+ 
Robert F. Smith


Henson Moore


Arlan Stangeland


Olympia Snowe


Gene Chapee


Tony Roth

United States Senate

COMMITTEE ON FINANCE
WASHINGTON, DC 20510

October 1, 1985

The Honorable Clayton Yeutter
U.S. Trade Representative
600 17th Street, N.W.
Washington, D.C. 20501

DEAR Mr. Ambassador:

We understand that the Canadian Government has initiated exploratory discussions on a possible free trade agreement between the United States and Canada.

We believe that the elected representatives of the people have a right to participate in this endeavor at the takeoff as well as the landing. We therefore strongly suggest that the pattern so well directed by Ambassador Strauss for the Tokyo Round agreements and the Trade Agreements Act of 1979, as well as the requirements for early consultation with the Finance Committee contained in the Trade and Tariff Act of 1984, be followed in this case.

In this connection, we reiterate our concern about Canadian softwood lumber imports, which benefit from below-market government stumpage prices that enable Canadian producers to undersell more efficient U.S. producers. Since 1975, Canadian imports have risen sharply, from 17 percent to 32 percent of U.S. consumption, contributing to significant unemployment and dislocation in the U.S. industry.

Any free trade agreement must be built on a foundation of mutually advantageous trading practices. Therefore, we believe that the Administration should seek an early resolution of the softwood lumber trade issue. This would facilitate Finance Committee consideration of any Administration proposals relating to the negotiation of a free trade agreement with Canada.

Sincerely,

Bob Packwood
Russell Long

Max Baucus
Steve Symms

THE
October 1, 1961
Page 2

Lloyd Bunker
Chuck Grassley

David Byrne

Markham Wallis

Gary Mitchell
John Henry

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Domestic Measures

Trade policy alone cannot provide long-term relief to the beleaguered U.S. softwood lumber industry. The recently-completed USITC report provides an excellent opportunity to highlight for Congress the non-trade factors which have a negative impact on U.S. competitiveness.

Except for the capital gains treatment for timber, we are not suggesting that the Administration take an advocacy position on these domestic policies. Highlighting these issues to both the domestic industry and its Congressional supporters could help shift some of the focus away from the trade policy arena.

Specifically, the domestic measures are:

1. Tax Treatment of Timber

Timber growing is one of the most tax-favored sectors of the U.S. economy. The President's Tax Reform Proposals included changes that would make the tax system more neutral across sectors of the economy and would lower marginal tax rates for individuals and corporations. Because of their favorable tax treatment under current law, the timber industry seeks relief from the provisions in the President's proposals that would more accurately measure their economic income. The Ways and Means Committee's tax reform proposal allows continued capital gains treatment of timber on private land for individuals and favorable treatment of preproductive expenses for producers with less than 75,000 acres. Further modifications to the President's proposals are likely during Senate consideration.

2. Forest Service Policies

The largest variable cost for lumber production is the cost of wood delivered to the mill. U.S. prices are higher than Canadian prices largely because of different stumpage pricing systems. This relates in part to U.S. Forest Service timber sales policies that are based upon biological, rather than economical standards. Under the concept of non-declining even flow, harvests are based upon the productive capacity of the forest. Consequently during periods of high demand, cutting remains constant, resulting in pressure on stumpage prices (which are auctioned). In recent years, speculation in solid wood markets, and Government legislation affecting areas available for timber harvest and volumes that can be cut have combined to cause

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- 2 -

bidding to go well in excess of estimated prices for cut sawtimber. It should be noted that 46 percent of all softwood lumber in the United States is on public lands, thus changes in this policy could have a significant impact on stumpage prices.

Not only would U.S. Forest Service policies need to be modified. The 1984 Federal Timber Contract Payment Modification Act sets a cap of 12.3 billion board feet on the volume of federal timber under contract each year in Forest Service Region 6 (the Pacific Northwest) and limits the annual sale program accordingly.

3. Jones Act

The Jones Act requires domestic companies to use U.S. flag vessels to ship products between U.S. ports. The Jones Act has effectively denied the U.S. softwood lumber industry in the Pacific Northwest use of lower cost foreign ocean shipping. For purposes of comparison, waterborne transport charges to Baltimore from Western Canada are 25 percent of landed value; U.S. rail charges from Portland to Baltimore were 39 percent of landed value. It has been calculated that the cost of shipping on U.S. flag carriers would range from \$54.26 per ton (with construction and operating subsidies) to \$101.34 per ton (with no subsidies). For comparison, shipping on foreign flag carriers is approximately \$44.40 per ton. To complicate matters, U.S. shippers contend that open hatch cargo vessels of the type commonly used by the forest products industry do not exist and would have to be built. While changes to the Jones Act are politically difficult, a single product exclusion has precedence, and one could argue that U.S. shipping interests would be unaffected as virtually no lumber now is carried on U.S. flag vessels. The current Administration position is opposition to changes in the Jones Act.

4. Rail Transportation

The Staggers Act of 1980 changed the rate-setting provisions under which U.S. railroads operate. The Act allows open competition between rail carriers for shipments over single rail lines. Boxcars and container traffic has been completely deregulated, with resultant lower rail rates. Further deregulation, especially for flatcars (on which most lumber would be shipped) could lead to more competitive rates for U.S. firms than those available to Canadian manufacturers. However, the current political outlook is dim for further deregulation.

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